4

Dividend and Interest Income

Dividends and interest paid to you in 1996 are reported to the IRS on Forms 1099.

You will receive copies of:

- Forms 1099-DIV, for dividends
- Forms 1099-INT, for interest
- Forms 1099-OID, for original issue discount

Report the amounts shown on the Forms 1099 on your tax return. The IRS uses the Forms 1099 to check the income you report. If you fail to report income reported on Forms 1099, you will receive a statement asking for an explanation and a bill for the tax deficiency. If you receive a Form 1099 that you believe is incorrect, contact the payer for a corrected form.

Do not attach your copies of Forms 1099 to your return. Keep them with a copy of your tax return.

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side.

Your social security number

Schedule B—Interest and Dividend Income

Attachment Sequence No. 08

Part I Interest Income

(See page B-1.)

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶

		Amount
National Savings Bank		925
Chase Manhattan Bank		515
Municipal Bonds		350
Total		1,790
Less: Tax Exempt Interest	1	(350)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

		Amount
2 Add the amounts on line 1	2	1,440
3 Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3	0
4 Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	1,440

Part II Dividend Income

(See page B-1.)

Note: *If you had over $400 in gross dividends and/or other distributions on stock, you must also complete Part III.*

5 List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8. ▶

		Amount
Auto Company		126
Bio-Chem Corp		217
Utility Corp		155
Mutual Fund XYZ		810
($500 ordinary dividend; $310 capital gain distribution)	5	

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

		Amount
6 Add the amounts on line 5	6	1,308
7 Capital gain distributions. Enter here and on Schedule D* (7)		
8 Nontaxable distributions. (See the inst. for Form 1040, line 9.) (8)		
9 Add lines 7 and 8	9	310
10 Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶	10	998

**If you do not need Schedule D to report any other gains or losses, see the instructions for Form 1040, line 13.*

Part III Foreign Accounts and Trusts

(See page B-2.)

If you had over $400 of interest or dividends or had a foreign account or were a grantor of, or a transferor to, a foreign trust, you must complete this part.

	Yes	No
11a At any time during 1996, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		✓
b If "Yes," enter the name of the foreign country ▶		
12 Were you the grantor of, or transferor to, a foreign trust that existed during 1996, whether or not you have any beneficial interest in it? If "Yes," you may have to file Form 3520, 3520-A, or 926		✓

Key to Dividend Reporting

Type of Dividend Payment—	*How and Where To Report—*
Cash dividends	Dividends paid out of a corporation's earnings and profits are taxable. The corporation will report taxable dividends to you on Form 1099-DIV (or equivalent statement). On Form 1040, report dividends on Line 9; Schedule B must be filed where total dividends exceed $400. If you file Form 1040A, report dividends on Line 9, and if total dividends exceed $400, complete Part II of Schedule 1. Dividends may not be reported on Form 1040EZ.
Dividends on accounts in credit unions, cooperative banks, savings and loan associations, mutual savings banks, and building and loan associations	Distributions from these financial institutions are called "dividends" but are actually interest and are reported to you on Form 1099-INT.
Life insurance policy dividends	Dividends on individual life insurance policies are actually a refund of your premiums and are not taxed unless they exceed the total premiums paid.
Money-market mutual-fund dividends	Cash dividends paid by a money-market mutual fund are reported on Form 1099-DIV. Report them on Line 9 of Form 1040, and include them on Schedule B if your total dividends exceed $400. On Form 1040A, report the dividends on Line 9, and fill out Part II of Schedule 1 if total dividends exceed $400. Do not confuse money-market funds managed by mutual funds with bank money-market accounts. Bank money-market accounts pay interest reported on Form 1099-INT, not dividends.
Mutual-fund dividends	Mutual funds may pay several kinds of dividends. On Form 1099-DIV, the fund will report total distributions in Box 1a. This total includes: (1) fully taxable ordinary dividends that are also reported in Box 1b of Form 1099-DIV; (2) long-term capital gain distributions that are also reported in Box 1c of Form 1099-DIV; and (3) nontaxable distributions that are also listed in Box 1d. Form 1099-DIV for 1996 will include dividends declared before the end of the year, even if not actually paid to you until January 1997. How to report these dividends on your return is detailed in ¶4.3.
Nominee distribution—joint accounts	If you receive dividends on stock held as a nominee for someone else, or you receive a Form 1099-DIV that includes dividends belonging to another person, such as a joint owner of the account, you are considered to be a "nominee recipient." If the other owner is someone other than your spouse, you should file a separate Form 1099-DIV showing you as the payer and the other owner as the recipient of the allocable income. Give the owner a copy of Form 1099-DIV by January 31, 1997, so the dividends can be reported on his or her 1996 return. File the Form 1099-DIV, together with a Form 1096 ("Transmittal of Information Return"), with the IRS by February 28, 1997. On your Schedule B, you list on Line 5 the total amount reported to you on Form 1099-DIV. Several lines above Line 6, subtract the nominee distribution (the amount allocable to the other owner) from the total dividends. Thus, the nominee distribution is not included in the taxable dividends shown on Line 6, Schedule B.
Return of capital distributions	A distribution that is not paid out of earnings is a nontaxable return of capital, that is, a partial payback of your investment. The company will report the distribution on Form 1099-DIV as a nontaxable distribution. You must reduce the cost basis of your stock by the nontaxable distribution. If your basis is reduced to zero by a return of capital distributions, any further distributions are taxable as capital gains, which you report on Schedule D. You must use Form 1040 if you received any return of capital distributions; Form 1040A or Form 1040EZ may not be used. If your total dividends, including nontaxable returns of capital, are $400 or less, you do not report the nontaxable distribution on your return unless your basis has been reduced to zero. In that case, further distributions are taxable and are reported on Schedule D. If your total dividends exceed $400, list the nontaxable dividend on Line 5 of Schedule B, along with your other dividends. Then, on Line 8, you subtract the nontaxable distribution from the total.
Stock dividends and stock splits	If you own common stock and receive additional shares of the same company as a dividend, the dividend is generally not taxed. A dividend is taxed where you had the option to receive cash instead of stock, or if the stock is of another corporation. Preferred shareholders are generally taxed on stock dividends. Taxable stock dividends are discussed at ¶4.7 and ¶4.8. Your corporation will determine whether stock dividends are taxable and report the taxable amount on Form 1099-DIV. If you receive additional shares as part of a stock split, the new shares are not taxable; although you own more shares, your ownership percentage has not changed.

Reporting Dividends

¶4.1 Reporting Dividend Income

Dividends paid out of current or accumulated earnings of a corporation are subject to tax. Most dividends fall into this class, except for stock dividends and stock rights on common stock which are generally not taxed; *see* ¶4.6.

Dividends that are paid to you during 1996 are reported to the IRS by the company on Form 1099-DIV. The IRS uses this information as a check on your reporting of dividends. You receive a copy of Form 1099-DIV. You do not have to attach it to your tax return.

Publicly held corporations generally inform stockholders of the tax consequences of stock dividends and other distributions. Keep such letters with your tax records. You may also want to consult investment publications such as Moody's or Standard & Poor's annual dividend record books for details of dividend distributions and their tax treatment.

¶4.2 Dividends From a Partnership, S Corporation, Estate, or Trust

You report dividend income you receive as a member of a partnership, stockholder in an S corporation, or as a beneficiary of an estate or trust. The fiduciary of the estate or trust should advise you of the dividend income to be reported on your return.

A distribution from a partnership or S corporation is reported as a dividend only if it is portfolio income derived from nonbusiness activities. Your allowable share of the dividend will be shown on the Schedule K-1 you receive from the partnership or S corporation.

¶4.3 How Mutual-Fund Dividends Are Taxed

Mutual funds (open-ended regulated investment companies) pay their shareholders several kinds of dividends and other distributions. Whether the dividend is received by you or reinvested by the fund, you must report it on your return.

The fund will send you Form 1099-DIV (or a similar written form), giving you a breakdown of the type of dividends paid during the taxable year. The Form 1099-DIV from your mutual fund may include several types of dividends or other distributions. The gross amount shown in Box 1a must be reported on your return. The Box 1a total includes ordinary dividends from Box 1b, capital gain distributions from Box 1c, nontaxable return of capital distributions from Box 1d, and in the case of a non–publicly offered fund, your share of fund expenses from Box 1e. *Dividends that you reinvested instead of receiving in cash are included in Box 1a.*

Dividends from a fund's foreign investments are included in the appropriate boxes of Form 1099-DIV, and the fund will indicate in Boxes 3 and 4 any foreign tax paid, which you may claim as a tax credit or deduction; *see* ¶36.14.

Form 1099-DIV for 1996 will include a dividend received in January 1997 so long as it was declared in October, November, or December of 1996.

See Chapter 32 for a closer look at the types of dividends reported on Form 1099-DIV, as well as the rules for figuring gain or loss when you sell mutual-fund shares.

¶4.4 Real Estate Investment Trust (REIT) Dividends

Dividends from a real estate investment trust (REIT) are shown on Form 1099-DIV. Ordinary dividends reported in Box 1b are fully taxable. Dividends designated by the trust as capital gain distributions in Box 1c are reported by you as long-term capital gains regardless of how long you have held your trust shares. A loss on the sale of REIT shares held for six months or less is treated as a long-term capital loss to the extent of any capital gain distribution received before the sale. However, this long-term loss rule does not apply to sales under periodic redemption plans.

¶4.5 Taxable Dividends of Earnings and Profits

You pay tax on dividends only when the corporation distributing the dividends has earnings and profits. Publicly held corporations will

tell you whether their distributions are taxable. If you hold stock in a close corporation, you may have to determine the tax status of its distribution. You need to know earnings and profits at two different periods:

1. Current earnings and profits as of the *end of the current taxable year.* A dividend is considered to have been made from earnings most recently accumulated.
2. Accumulated earnings and profits as of the *beginning of the current year.* However, when current earnings and profits are large enough to meet the dividend, you do not have to make this computation. It is only when the dividends exceed current earnings (or there are no current earnings) that you match accumulated earnings against the dividend.

The tax term "accumulated earnings and profits" is similar in meaning to the accounting term "retained earnings." Both stand for the net profits of the company after deducting distributions to stockholders. However, "tax" earnings may differ from "retained earnings" for the following reason: Surplus accounts, the additions to which are not deductible for income tax purposes, are ordinarily included as tax earnings.

EXAMPLES

1. During 1996, Corporation A paid dividends of $25,000. At the beginning of 1996 it had accumulated earnings of $50,000. It lost $25,000 during 1996. You are fully taxed on your dividend income in 1996 because the corporation's net accumulated surplus exceeds its dividends.
2. At the end of 1995, Corporation B had a deficit of $200,000. Earnings for 1996 were $100,000. In 1996, it paid stockholders $25,000. The dividends are taxed; earnings exceeded the dividends.

¶4.6 Stock Dividends on Common Stock

If you own common stock in a company and receive additional shares of the same company as a dividend, the dividend is generally not taxable; *see* ¶30.4 and ¶30.5 for the method of computing cost basis of stock dividends and rights and sales of such stock.

Exceptions to tax-free rule. A stock dividend on common stock is taxable when (1) you may elect to take either stock or cash; (2) there are different classes of common stock, one class receiving cash dividends and another class receiving stock; or (3) the dividend is of convertible preferred stock; *see* ¶4.8 for further details on taxable stock dividends.

Stock Splits Are Not Taxed

The receipt of stock under a split-up is not taxable. Stock splits resemble the receipt of stock dividends, but they are not dividends. They do not represent a distribution of surplus as in the case of stock dividends. The purpose of a split-up is generally to reduce the price of individual shares in order to increase their marketability. The basis of the old holding is divided among the new shares in order to find the basis for the new shares; *see* ¶30.4.

Fractional shares. If a stock dividend is declared and you are only entitled to a fractional share, you may be given cash instead. To save the trouble and expense of issuing fractional shares, many companies directly issue cash in lieu of fractional shares or they set up a plan, with shareholder approval, for the fractional shares to be sold and the cash proceeds distributed to the shareholders. Your company should tell you how to report the cash payment. According to the IRS, you are generally treated as receiving a tax-free dividend of fractional shares, followed by a taxable redemption of the shares by the company. You report on Schedule D capital gain or loss equal to the excess of the cash over the basis of the fractional share; long- or short-term treatment depends on the holding period of the original stock. In certain cases, a cash distribution may be taxed as an ordinary dividend and not as a sale reported on Schedule D; your company should tell you if this is the case.

Stock rights. The rules that apply to stock dividends also apply to distributions of stock rights. If you, as a common stockholder, receive rights to subscribe to additional common stock, the receipt of the rights is not taxable provided the terms of the distribution do not fall within the taxable distribution rules of ¶4.8.

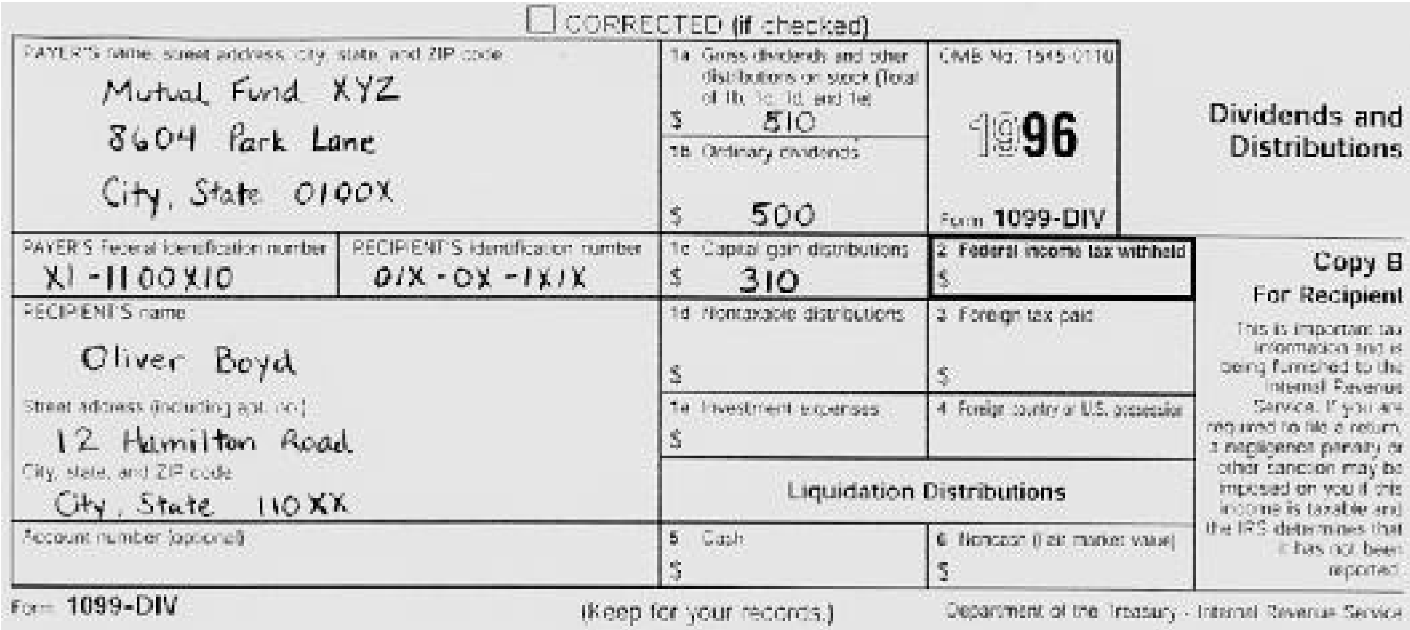
¶4.7 Dividends Paid in Property

A dividend may be paid in property such as securities of another corporation or merchandise. You report as income the fair market value of the property. A dividend paid in property is sometimes called a *dividend in kind.*

EXAMPLE

You receive one share of X corporation stock as a dividend from the G company of which you are a stockholder. You received the X stock when it had a market value of $25; you report $25, the value of the property received.

Corporate benefits. On an audit, the IRS may charge that a benefit given to a shareholder-employee is a taxable dividend.


CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code
Mutual Fund XYZ
8604 Park Lane
City, State 0100X

1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $ 510
1b Ordinary dividends $ 500

OMB No. 1545-0110
1996
Form 1099-DIV

Dividends and Distributions

PAYER'S Federal identification number: X1-1100X10
RECIPIENT'S identification number: 01X-0X-1X1X

1c Capital gain distributions $ 310
2 Federal income tax withheld $

Copy B
For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

RECIPIENT'S name
Oliver Boyd

1d Nontaxable distributions $
3 Foreign tax paid $

Street address (including apt. no.)
12 Hamilton Road

1e Investment expenses $
4 Foreign country or U.S. possession

City, state, and ZIP code
City, State 110XX

Liquidation Distributions

Account number (optional)

5 Cash $
6 Noncash (Fair market value) $

Form 1099-DIV (Keep for your records.) Department of the Treasury - Internal Revenue Service

¶4.8 Taxable Stock Dividends

The most frequent type of stock dividend is not taxable: the receipt by a common stockholder of a common stock dividend; *see* ¶4.6.

Dividend Reinvestment in Company Stock

Your company may allow you to take either cash dividends or automatically reinvest the dividends in company stock. If you elect the stock plan, and pay fair market value for the stock, the full cash dividend is taxable.

If the plan lets you buy the stock at a discount price, the amount of the taxable dividend is the fair market value of the stock on the dividend payment date, plus any service fee charged for the acquisition. The basis of the stock is also fair market value at the dividend payment date. The service charge may be claimed as an itemized deduction subject to the 2% adjusted gross income floor; *see* ¶19.24. If at the same time you also have the option to buy additional stock at a discount and you exercise the option, you have additional dividend income for the difference between the fair market value of the optional shares and the amount you paid for the shares.

Taxable stock dividends. The following stock dividends are taxable:

- Stock dividends paid to holders of preferred stock. However, no taxable income is realized where the conversion ratio of convertible preferred stock is increased only to take account of a stock dividend or split involving the stock into which the convertible stock is convertible.
- Stock dividend elected by a shareholder of common stock who had the choice of taking stock, property, or cash. A distribution of stock that was immediately redeemable for cash at the stockholder's option was treated as a taxable dividend.
- Stock dividend paid in a distribution where some shareholders receive property or cash and other shareholders' proportionate interests in the assets, or earnings and profits of the corporation are increased.
- Distributions of preferred stock to some common shareholders and common stock to other common shareholders.
- Distributions of convertible preferred stock to holders of common stock, unless it can be shown that the distribution will not result in the creation of disproportionate stock interests.

Constructive stock dividends. You may not actually receive a stock dividend, but under certain circumstances, the IRS may treat you as having received a taxable distribution. This may happen when a company increases the ratio of convertible preferred stock.

¶4.9 Who Reports the Dividends

Stock held by broker in street name. If your broker holds stock for you in a street name, dividends earned on this stock are received by the broker and credited to your account. You report all dividends credited to your account in 1996. The broker is required to file an information return on Form 1099 (or similar form) showing all such dividends.

If your statement shows only a gross amount of dividends, check with your broker if any of the dividends represented nontaxable returns of capital.

Dividends on stock sold or bought between ex-dividend date and record date. Record date is the date set by a company on which you must be listed as a stockholder on its records to receive the dividend. However, in the case of publicly traded stock, an ex-dividend date, which usually precedes the record date by several business days, is fixed by the exchange to determine who is entitled to the dividend.

If you buy stock before the ex-dividend date, the dividend belongs to you and is reported by you. If you buy on or after the ex-dividend date, the dividend belongs to the seller.

If you sell stock before the ex-dividend date, you do not have a right to the dividend. If you sell on or after the ex-dividend date, you receive the dividend and report it as income.

The dividend declaration date and date of payment do not determine who receives the dividend.

Stock sold short. For a discussion of how to treat a payment to a broker for dividends paid on stock sold short, *see* ¶30.6.

Nominees. If you receive dividends on stock held as a nominee for another person, other than your spouse, give that owner a Form 1099-DIV and file a copy of that return with the IRS, along with a Form 1096 ("Transmittal of U.S. Information Return"). The actual owner then reports the income. List the nominee dividends on Schedule B of Form 1040 (or Schedule 1, Form 1040A) along with your other dividends, and then subtract the nominee dividends from the total. Follow the same procedure if you receive a Form 1099-DIV for an account owned jointly with someone other than your spouse. Give the other owner a Form 1099-DIV, and file a copy with the IRS, along with a Form 1096. The other owner then reports his or her share of the joint income. On your return, you list the total dividends shown on Forms 1099-DIV and avoid tax by subtracting from the total the nominee dividends reported to the other owner.

EXAMPLE

You receive Form 1099-DIV showing dividends of $960 including a $200 nominee distribution. You prepare a Form 1099-DIV for the actual owner showing the $200 distribution, and file a copy of the form with the IRS, plus Form 1096. On your own Schedule B, report the nominee distribution along with your other dividends and then subtract it from the total.

Dividend Income	*Amount*
Mutual Fund	$310
Computer Inc.	450
Utility Inc.	200
Subtotal	$960
Less: Nominee distribution	(200)
Net dividends	$760

¶4.10 Year Dividends Are Reported

Dividends are generally reported on the tax return for the year in which the dividend is unqualifiedly credited to your account or when you receive the dividend check. However, a dividend declared in December by a mutual fund (¶4.3) is taxable in the year it is declared, if it is paid before February 1 of the following year.

Dividends received from a corporation in a year after the one in which they were declared, when you held the stock on the record date, are taxed in the year they are received; *see* Example 4 below.

EXAMPLES

1. A corporation declares a dividend payable on December 20, 1996. It follows a practice of paying dividends by checks that are mailed so that stockholders do not receive them until January 1997. You report this dividend on your 1997 return.
2. On December 30, 1996, a dividend is declared by a mutual fund. You receive it in January 1997. The dividend is taxable in 1995, when it is declared, and not 1997 when it is received.
3. On December 30, 1996, a dividend is credited by a corporation to a stockholder's account. The dividend is taxable in 1996, as the crediting is considered constructive receipt in 1996, even though the dividend is not paid until 1997 or a later year.
4. You own stock in a corporation. In April 1995, the corporation declared a dividend. But it provided that the dividend will be paid when it gets the cash. It finally pays the dividend in September 1996; the dividend is taxable in 1996.

¶4.11 Distribution Not Out of Earnings: Return of Capital

A return of capital or "nontaxable distribution" reduces the cost basis of the stock. If your shares were purchased at different times, reduce the basis of the oldest shares first. When the cost basis is reduced to zero, further returns of capital are taxed as capital gains on Schedule D, or on Line 13 of Form 1040 if you do not need Schedule D to report other transactions. Whether the gain is short-term or long term depends on the length of time you have held the stock. The company paying the dividend will usually inform you of the tax treatment of the payment.

Life insurance dividends. Dividends on insurance policies are not true dividends. They are returns of premiums you previously paid. They reduce the cost of the policy and are not subject to tax until they exceed the net premiums paid for the contract. Interest paid or credited on dividends left with the insurance company is taxable. Dividends on VA insurance are tax free, as is interest on dividends left with the VA.

Where insurance premiums were deducted as a business expense in prior years, receipts of insurance dividends are either included in income or taken as a reduction of the insurance expense deduction of the current year. Dividends on capital stock of an insurance company are taxable.

Reporting Interest Income

	See ¶
Reporting interest on your tax return	4.12
Interest on frozen accounts not taxed	4.13
Interest income on debts owed you	4.14
Reporting interest on bonds bought or sold	4.15
Forfeiture of interest on premature withdrawals	4.16

¶4.12 Reporting Interest on Your Tax Return

You must report all taxable interest. If you earn over $400 of taxable interest, you list the payers of interest on Schedule B if you file Form 1040, or on Part I of Schedule 1 if you file Form 1040A. Form 1040EZ may not be used if your taxable interest exceeds $400. You must also list tax-exempt interest on your return even though it is not taxable.

You must also list interest that has been shown on Forms 1099 in your name although it may not be taxable to you. For example, you may have received interest as a nominee or as accrued interest on bonds bought between interest dates. In these cases, list the amounts reported on Form 1099 along with your other interest income on Schedule B if you file Form 1040, or Schedule 1 if you file Form 1040A. On a separate line, label the amount as "Nominee distribution," or "Accrued interest," and subtract it from the total interest shown. Accrued interest is discussed at ¶4.15 and in the chart on page 64. Nominee distributions are discussed further in the chart on page 64.

If you received interest on a frozen account (¶4.13), include the interest from Form 1099 on Schedule B if you file Form 1040, or on Schedule 1 if you use Form 1040A. On a separate line, write "frozen deposits" and subtract the amount from the total interest reported.

You do not have to list the payers of interest if your interest receipts are $400 or less, unless you have to reduce the interest shown on Form 1099 by nontaxable amounts such as accrued interest, nominee distributions, or frozen deposit interest.

Joint accounts. If you receive a Form 1099-INT for interest on an account you own with someone other than your spouse, you should file a nominee Form 1099-INT with the IRS to indicate that person's share of the interest, together with Form 1096 ("Transmittal of Information Return"). Give a copy of the Form 1099-INT to the other person. When you file your own return, you report the total interest shown on Form 1099-INT and then subtract the other person's share so you are taxed only on your portion of the interest; *see* the Example below.

Do not follow this procedure if you contributed all of the funds and set up the joint account merely as a "convenience" account to allow the other person to automatically inherit the account when you die. In this case, you report all of the interest income.

EXAMPLE

Your Social Security number is listed on a bank account owned jointly with your sister. You each invested 50% of the account principal and have agreed to share the interest income. You receive a Form 1099-INT for 1996 reporting total interest of $1,500 on the account. By January 31, 1997, prepare and give to your sister another Form 1099-INT which identifies you as the payer and her as the recipient of her share, or $750 interest. Send a copy of the Form 1099-INT and a Form 1096 to the IRS no later than February 28, 1997. Your sister will report the $750 interest on her return. On your Form 1040, report the full $1,500 interest on Line 1 of Schedule B, along with your other interest income. Above Line 2, subtract the $750 belonging to your sister to avoid being taxed on that amount; label the subtraction "Nominee distribution."

¶4.13 Interest on Frozen Accounts Not Taxed

If you have funds in a bankrupt or insolvent financial institution that "freezes" your account by limiting withdrawals, you do not pay tax on interest allocable to the "frozen" deposits. The interest is taxable when withdrawals are permitted. Officers and owners of at least a 1% interest in the financial institution, or their relatives, may not take advantage of this rule and must still report interest on frozen deposits.

If you report interest on Schedule B of Form 1040 or on Schedule 1 of Form 1040A, report the full amount shown on Form 1099-INT, even if the interest is on a "frozen" deposit. Then, on a separate line, subtract the amount allocable to the frozen deposit from the total interest shown on the Schedule; label the subtraction "frozen deposits." Thus the interest on the frozen deposit is not included on the line of your return showing taxable interest.

Lost deposits. If you lose funds because of a financial institution's bankruptcy or insolvency, and you can reasonably estimate such a loss, you may deduct the loss as a nonbusiness bad debt, as a casualty loss, or as a miscellaneous itemized deduction; *see* ¶18.4.

Refund opportunity. If you reported interest on a frozen deposit on a tax return for 1993–1995, you may file a refund claim for the tax paid on the interest; *see* Chapter 38.

¶4.14 Interest Income on Debts Owed You

You report interest earned on money which you loan to another person. If you are on the cash basis, you report interest in the year you actually receive it or when it is considered received under the "constructive receipt rule." If you are on the accrual basis, you report interest when it is earned, whether or not you have received it.

See ¶4.31 for minimum interest rates required for loans and ¶4.18 when OID rules apply.

Where partial payment is being made on a debt, or when a debt is being compromised, the parties may agree in advance which part of the payment covers interest and principal. If a payment is not identified as either principal or interest, the payment is first applied against interest due and reported as interest income to the extent of the interest due.

Interest income is not realized when a debtor gives you a new note for an old note where the new note includes the interest due on the old note.

If you give away a debtor's note, you report as income the collectible interest due at the date of the gift. To avoid tax on the interest, the note must be transferred before interest becomes due.

¶4.15 Reporting Interest on Bonds Bought or Sold

Where you buy or sell bonds between interest dates, interest is included in the price of the bonds. The purchaser does not report as income the interest that accrued before he or she owned the bond. The seller reports the accrued interest. The purchaser reduces the basis of the bond by the accrued interest reported by the seller. The following Examples illustrate these rules.

EXAMPLES

1. *Purchase*. On April 30, you buy for $5,250 a $5,000 corporate bond bearing interest at 8% per year, payable January 1 and July 1. The purchase price of the bond included accrued interest of $133 for the period January 1– April 30.

Interest received on 7/1	$200
Less: Accrued interest	133
Taxable interest	$ 67

Form 1099 sent to you includes the $133 of accrued interest. On Schedule B of Form 1040, you report the total interest of $200 received on July 1 and then on a separate line subtract the accrued interest of $133. Write "Accrued Interest" on the line where you show the subtraction.

Your basis for the bond is $5,117 ($5,250 –$133) for purposes of figuring gain or loss on a later sale of the bond.

2. *Sale.* On April 30, you sell for $5,250 a $5,000 8% bond with interest payable January 1 and July 1. The sales price included interest of $133 accrued from January 1– April 30. Your cost for the bond was $5,000. On your return, you report interest of $133 and capital gain of $117.

You receive	$5,250
Less: Accrued interest	133
Sales proceeds	$5,117
Less: Your cost	5,000
Capital gain	$ 117

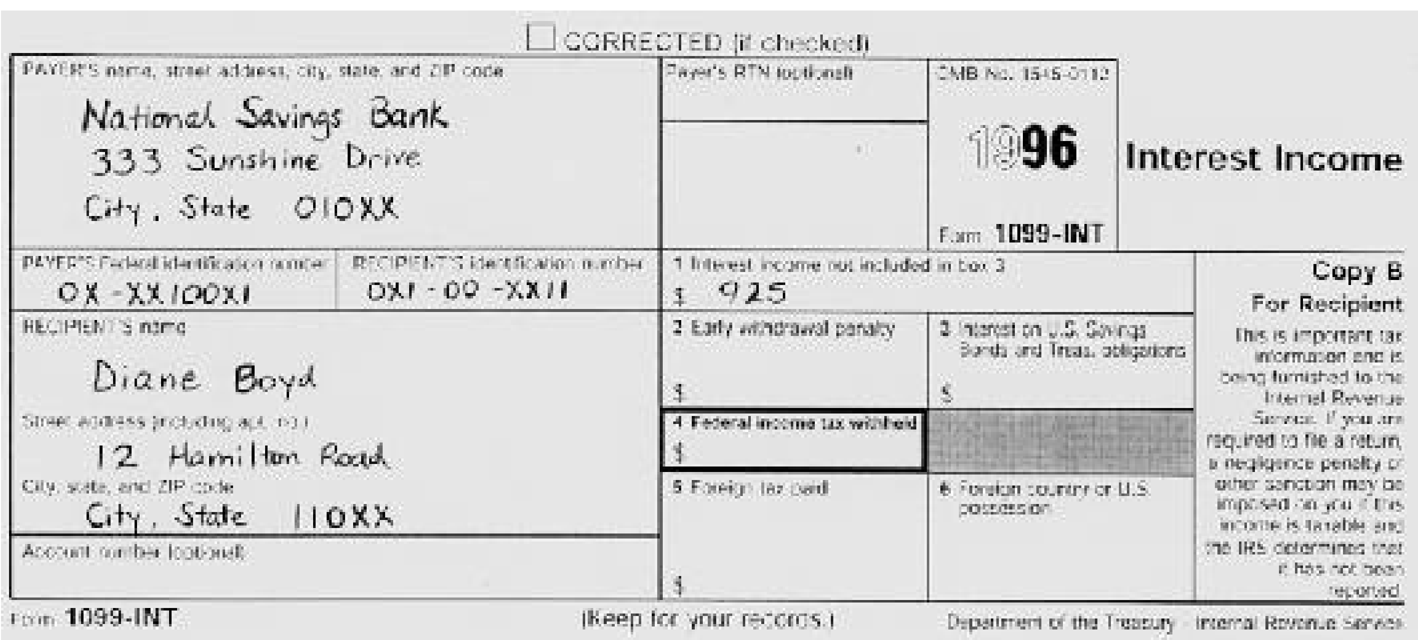
Redemptions, bankruptcy, reorganizations. On a redemption, interest received in excess of the amount due at that time is not treated as interest income.

EXAMPLE

You hold a $5,000 9% bond with interest payable January 1 and July 1. The company can call the bonds for redemption on any interest date. In May, the company announces it will redeem the bonds on July 1. But you may present the bond for redemption beginning with June 1 and it will be redeemed with interest to July 1. On June 1 you present the bond and receive $5,225 – $5,000 principal, $187.50 interest to June 1, and $37.50 extra interest to July 1. The $37.50 is treated as a capital gain; the $187.50 is interest.

Who Reports Interest Income

If interest is—	*It is reported by—*
Joint account interest	The person whose Social Security number is reported to the bank (or other payer) on Form W-9 when the account is opened. If the other owner is not your spouse, and you receive a Form 1099-INT for the interest, you should report all the income on your return and also file a nominee Form 1099-INT with the other owner to indicate the other owner's share of the interest. These rules are discussed in the next item. Do not file a nominee form if you contributed all the funds and named a joint owner so that he or she may automatically inherit the account. You report all the interest.
Nominee distribution	If you receive a Form 1099-INT that includes interest belonging to someone other than you or your spouse, file a nominee Form 1099-INT with the IRS to indicate that person's income, and give a copy to that person. Complete a Form 1099-INT on which you are listed as the payer and the other person is listed as the recipient. Give the Form 1099-INT to the other owner by January 31, 1997. File Form 1099-INT plus Form 1096 ("Transmittal of Information Return") with the IRS by February 28, 1997. On your own Form 1040 or Form 1040A, you list the nominee interest, along with the other interest reported to you on Forms 1099-INT. Then subtract the nominee interest from the total. *See* ¶4.12 for an example of nominee reporting.
Accrued interest on a bond bought between interest payment dates	Interest accrued between interest payment dates is part of the purchase price of the bond. This amount is taxable to the seller as explained at ¶4.15. If you received a Form 1099-INT that includes accrued interest on a bond, include the interest on Line 1 of Schedule B, and then on a separate line above Line 2 subtract the accrued interest from the Line 1 total.
Custodian account of a minor (Uniform Gifts to Minors Act)	The interest is taxable to the child. For a child under age 14, net investment income exceeding $1,300 is subject to tax at the parent's top tax rate; *see* Chapter 24.


CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code
National Savings Bank
333 Sunshine Drive
City, State 010XX

Payer's RTN (optional)

OMB No. 1545-0112
1996
Form 1099-INT
Interest Income

PAYER'S Federal identification number: 0X-XX100X1
RECIPIENT'S identification number: 0X1-00-XX11

1 Interest income not included in box 3
$ 925

RECIPIENT'S name
Diane Boyd

Street address (including apt. no.)
12 Hamilton Road

City, state, and ZIP code
City, State 110XX

Account number (optional)

2 Early withdrawal penalty
$

3 Interest on U.S. Savings Bonds and Treas. obligations
$

4 Federal income tax withheld
$

5 Foreign tax paid
$

6 Foreign country or U.S. possession

Copy B
For Recipient
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form 1099-INT (Keep for your records.) Department of the Treasury - Internal Revenue Service

Key to Interest Income Rules

Item—	*Pointer—*
Forms 1099-INT	Forms 1099-INT, sent by payers of interest income, simplify the reporting of interest income. The forms give you the amount of interest to enter on your tax return. Although they are generally correct, you should check for mistakes and notify payers of any error and request a form marked "corrected." If tax was withheld (¶26.12), claim this tax as a payment on your tax return. The IRS will check interest reported on your return against the Forms 1099-INT sent by banks and other payers.
Deposits in a savings account	Interest credited to your account in 1996 is taxable for 1996. This is true for a "passbook" savings account even though you do not present your passbook to have the interest entered. Dividends on deposits or accounts in the following institutions are reported as interest income: mutual savings banks; cooperative banks; domestic building and loan associations; and domestic and federal savings and loan associations.
Savings certificates, deferred interest	The interest element on certificates of deposit and similar plans of more than one year is treated as original issue discount (OID) and is taxable on an annual basis. The bank notifies you of the taxable OID amount on Form 1099-OID. If you discontinue a savings plan before maturity, you may have a loss deduction for forfeited interest, which is listed on Form 1099-INT or Form 1099-OID; *see* ¶4.16. Tax on interest can be deferred on a savings certificate with a term of one year or less. Interest is taxable in the year it is available for withdrawal without substantial penalty. Where you invest in a six-month certificate before July 1, the entire amount of interest is paid six months later and is taxable in the year of payment. However, when you invest in a six-month certificate after June 30, only interest actually paid or made available for withdrawal without substantial penalty is taxable in the year of issuance. The balance is taxable in the year of maturity. You can defer interest to the following year by investing in a six-month certificate after June 30, provided the payment of interest is specifically deferred to the year of maturity by the terms of the certificate. Similarly, interest may be deferred to the following year by investing in longer term certificates of up to one year, provided that the crediting of interest is specifically deferred until the year of maturity.
U.S. Savings Bonds—Series E, EE	The increase in redemption value of these Savings Bonds is interest income. You do not have to report the annual increase in value until the year in which you cash the bond or the year in which the bond finally matures, whichever is earlier; *see* ¶4.28.
U.S. Savings Bonds—Series H, HH	Semiannual interest on these bonds is taxable when received.
U.S. Treasury bills	If your T-bill matured in 1996, report as interest the difference between the amount received at redemption and your cost. If in 1996 you sold a bill before maturity, you may have a capital loss, or a gain that is partly interest income and partly capital gain; *see* ¶4.27.
Zero Coupon Bonds	The interest element is treated as original issue discount (OID) and is taxable annually. You receive a Form 1099-OID reporting the taxable amount.
Interest on funds invested abroad	Interest must be reported in U.S. dollars. If foreign tax has been paid, you may be entitled to a deduction or credit; *see* ¶36.14. *See also* ¶36.12 for blocked currency reporting rules.
Bearer or coupon bonds	Interest coupons due and payable in 1996 are taxable on your 1996 return regardless of when they were presented for collection. For example, a coupon due January 1996 and presented for payment in 1995 is taxable in 1996. Similarly, a coupon due December 1996 but presented for payment in 1997 is taxable in 1996.
Corporate obligations in registered form	You report interest when received or made available to you. *See* ¶4.15 on how to treat interest when you buy or sell bonds between interest dates.
Interest on state and local government obligations	Although you may receive a Form 1099-INT for interest on state or municipal bonds, you do not pay federal tax on the interest. You are required to list the tax-exempt interest on your tax return, although it is not taxable. The interest may be subject to state income tax.
Borrowing to meet minimum deposit requirements for savings certificates	Interest expenses may be deductible as itemized investment interest deductions (¶15.10). Report the full amount of interest income listed on Form 1099-INT, even if you do not take interest deductions.
Insurance proceeds	You report interest paid on insurance proceeds left with an insurance company or included in installment payments (under optional modes of payment). Exception: A surviving spouse of an insured person who died before October 23, 1986, is not taxed on up to $1,000 a year of interest included in installment payments.
Interest on prepaid premium	Taxable interest is reported by insurance company on Form 1099-INT.
Interest on tax refunds	Interest on tax refunds is fully taxable.
Bank gifts	To attract new deposits, banks and thrifts may offer cash, televisions, toasters, and the like as inducements. The gifts are taxable as interest and reported on Form 1099-INT.
Interest on withdrawn life insurance dividends	If you can withdraw the interest annually, you report the interest in the year it is credited to your account. However, if, under the terms of the insurance policy, the interest can be withdrawn only on the anniversary date of the policy (or some other specified date), then you report the interest in the year in which the anniversary date of the policy (or some other specified date) falls. Interest on GI insurance dividends on deposit with the Department of Veterans Affairs (VA) is not taxable; *see* ¶35.2.

Taxable interest may continue on bonds after the issuer becomes bankrupt, if a guarantor continues to pay the interest when due. The loss on the bonds will occur only when they mature and are not redeemed or when they are sold below your cost. In the meantime, the interest received from the guarantor is taxed.

Bondholders exchanging their bonds for stock, securities, or other property in a tax-free reorganization, including a reorganization in bankruptcy, have interest income to the extent the property received is attributable to accrued but unpaid interest. *See* Internal Revenue Code Section 354 for further details.

Bonds selling at a flat price. When you buy bonds with defaulted interest at a "flat" price, a later payment of the defaulted interest is not taxed. It is a tax-free return of capital that reduces your cost of the bond. This rule applies only to interest in default at the time the bond is purchased. Interest that accrues after the date of your purchase is taxed as ordinary income.

¶4.16 Forfeiture of Interest on Premature Withdrawals

Banks usually impose an interest penalty if you withdraw funds from a savings certificate before the specified maturity date. You may lose interest if you prematurely withdraw funds in order to switch to higher paying investments, or if you need the funds for personal use. In some cases, the penalty may exceed the interest earned so that principal is also forfeited to make up the difference.

If you are penalized, you must still report the full amount of interest credited to your account. However, on Form 1040, you may deduct the full amount of the penalty-forfeited principal as well as interest. The deductible penalty-forfeited amount is shown in Box 2 of Form 1099-INT sent to you. You may claim the deduction, even if you do not itemize deductions. On Form 1040, enter the deduction on Line 28, marked "Penalty on early withdrawal of savings."

Loss on redemption before maturity of a savings certificate. If you redeem a long-term (more than one year) savings certificate for a price less than the stated redemption price at maturity, you are allowed a loss deduction for the amount of original issue discount (OID) reported as income but not received. The amount of the loss is the excess of: (1) the OID reported as income for the period you held the certificate, over (2) the excess of the amount received upon the redemption over the issue price. Claim the deduction on Line 30 of Form 1040. The basis of the obligation is reduced by the amount of the deductible loss.

Do not include in the computation any amount based on a fixed rate of simple or compound interest that is actually payable or is treated as constructively received at fixed periodic intervals of one year or less.

Premiums and Discounts on Bonds

¶4.17 Amortization of Bond Premium

Bond premium is the extra amount paid for a bond in excess of its principal or face amount when the value of the bond has increased due to falling interest rates. Investors may elect to amortize the premium on a taxable bond by deducting it over the life of the bond. Amortizing the premium annually is usually advantageous because it gives an annual deduction to offset the interest income from the bond. Basis of the bond is reduced by the amortized premium. If you claim amortization deductions and hold the bond to maturity, basis is reduced by the entire amortized premium and you have neither gain nor loss at redemption.

You may not claim a deduction for a premium paid on a *tax-exempt* bond; however, you must still decrease your basis by the premium.

Dealers in bonds may not deduct amortization but must include the premium as part of cost.

Capital loss alternative to amortizing premium. If you do not elect to amortize the premium on a taxable bond, you will realize a capital loss when the bond is redeemed at par or you sell it for less than you paid for it. For example, if you bought a $1,000 corporate bond several years ago for $1,300 and did not amortize the $300 premium, you will realize a $300 capital loss when the bond is redeemed at par: $1,000 proceeds less $1,300 cost basis ($1,000 face value plus $300 premium).

You could realize a capital gain if you sell the bond for more than the premium price you paid.

Determining the amortizable amount for the year. The amortizable premium for the year is based on the yield-to-maturity method (also called constant-yield method) if the bond was issued after September 27, 1985. This method is the same as the optional constant-yield method for reporting market discount discussed at ¶4.20. You should see IRS Publication 1212 or consult a tax professional for making the complex computations.

For bonds issued before September 28, 1985, a monthly straight-line method or a constant-yield method based upon IRS Revenue Ruling 82-10 could be used.

For taxable bonds subject to a *call* before maturity, the amortization computation is based on the earlier call date if that results in a smaller amortization deduction.

How To Deduct Amortized Premium

If you paid a premium on a taxable bond during 1996, you offset interest income on the bond by the amortizable premium. You must file Form 1040 and show the reduction on Schedule B. Report the full interest from the bond on Line 1 of Schedule B, along with the rest of your interest income. On a separate line, subtract the premium from a subtotal of the other interest. Label the subtraction "ABP Adjustment."

This interest offset rule applies to all taxable bonds acquired at a premium after 1987; *see* below for bonds acquired before 1988.

Taxable bonds acquired before 1988. You also may offset interest income by the amortizable premium for bonds acquired after October 22, 1986, but before 1988; otherwise, the allocated premium must be treated as investment interest subject to the limits at ¶15.10.

For bonds acquired before October 23, 1986, the allocable premium is fully deductible on Schedule A as a miscellaneous deduction not subject to the 2% floor (¶19.1).

Effect of amortization election on other bonds you acquire. The election to amortize does not have to be made in the year you acquire the bond. If you elect to amortize the premium for one bond, you must also amortize the premium on all similar bonds owned by you at the beginning of the tax year, and also to all similar bonds acquired thereafter. An election to amortize may not be revoked without IRS permission. If you file your return without claiming the deduction, you may not change your mind and make the election for that year by filing an amended return or refund claim. If an election is made after the first year, the premium allocable to earlier years is included in your cost basis for the bond and will result in capital loss when the bond is redeemed at par or sold for less than basis.

Amortized Premium Reduces Basis

You reduce the cost basis of the bond by the amount of the premium taken as a deduction.

If you hold the bond to maturity, the entire premium is amortized and you have neither gain nor loss on redemption of the bond. If before maturity you sell the bond at a gain (selling price exceeds your basis for the bond), you realize long-term capital gain if you held the bond long term. A sale of the bond for less than its adjusted basis gives a capital loss.

Callable bonds. On taxable bonds, amortization is based either on the maturity or earlier call date, depending on which date gives a smaller yearly deduction. This rule applies regardless of the issue date of the bond. If the bond is called before maturity, you may deduct as an ordinary loss the unamortized bond premium in the year the bond is redeemed.

Convertible bonds. A premium paid for a convertible bond that is allocated to the conversion feature may not be amortized.

Tax-exempt bonds. You may not take a deduction for the amortization of a premium paid on a tax-exempt bond. When you dispose of the bond, you amortize the premium for the period you held the bond and reduce the basis of the bond by the amortized amount.

If the bond has call dates, the IRS may require the premium to be amortized to the earliest call date.

Acquisition premium paid on bonds with original issue discount. If you paid more than the original issue price plus accumulated OID from the date of issue, that excess, called *acquisition premium*, reduces the amount of OID that you have to include in income; *see* ¶4.18.

¶4.18 Discount on Bonds

There are two types of bond discounts: original issue discount and market discount.

Market discount. Market discount arises when the price of a bond declines because its interest rate is less than the current interest rate. For example, a bond originally issued at its face amount of $1,000 declines in value to $900 because the interest payable on the bond is less than the current interest rate. The difference of $100 is called market discount. The tax treatment of market discount is explained in ¶4.20.

Original issue discount (OID). OID arises when a bond is issued for a price less than its face or principal amount. OID is the difference between the principal amount (redemption price at maturity) and the issue price. For publicly offered obligations, the issue price is the initial offering price to the public at which a substantial amount of such obligations were sold. All obligations that pay no interest before maturity, such as zero coupon bonds, are considered to be issued at a discount. For example, a bond with a face amount of $1,000 is issued at an offering price of $900. The $100 difference is OID.

Generally, part of the OID must be reported as interest income each year you hold the bond, whether or not you receive any payment from the bond issuer. This is also true for certificates of deposit (CDs), time deposits, and similar savings arrangements with a term of more than one year, provided payment of interest is deferred until maturity. OID is reported to you by the issuer (or by your broker if you bought the obligation on a secondary market) on Form 1099-OID; *see* ¶4.19 for reporting OID.

Bond bought at premium or acquisition premium. If you pay more than the face amount for a bond originally issued at a discount, you do *not* report OID as ordinary income. When you dispose of a bond bought at a premium, the difference between the sale or redemption price and your basis is a capital gain or loss; *see* ¶4.17.

However, this rule does not apply if you pay more than the original issue price plus accumulated OID from the date of issue. Your excess payment, called the "acquisition premium," reduces the amount of OID you must report as income. The rules for computing the reduction to OID depend on when the bond was purchased. For bonds purchased after July 18, 1984, OID is reduced by a fraction, the numerator of which is the acquisition premium; the denominator is the OID remaining after your purchase date to the maturity date. *See* IRS Publication 1212 for further details on how to make the computation.

Exceptions to OID. OID rules do not apply to: (1) obligations with a term of one year or less held by cash-basis taxpayers; *see* ¶4.21; (2) tax-exempt obligations, except for certain stripped tax-exempts; *see* ¶4.26; (3) U.S. Savings Bonds; (4) an obligation issued by an individual before March 2, 1984; and (5) loans of $10,000 or less from individuals.

You may disregard OID that is less than one-fourth of one percent (.0025) of the principal amount multiplied by the number of full years from the date of original issue to maturity. On most long-term bonds, the OID will exceed this amount and must be reported.

EXAMPLES

1. A 10-year bond with a face amount of $1,000 is issued at $980. One-fourth of one percent (.0025) of $1,000 times 10 is $25. As the $20 OID is less than $25, it may be ignored for tax purposes.
2. Same facts as in Example 1 except that the bond is issued at $950. As OID of $50 is more than the $25, OID must be reported under the rules explained at ¶4.19.

¶4.19 How To Report Original Issue Discount (OID) on Your Return

The issuer of the bond (or your broker) will make the OID computation and report to you in Box 1 of Form 1099-OID the OID for the actual dates of your ownership during the calendar year. However, the amount shown in Box 1 of Form 1099-OID must be adjusted if you bought the obligation at a premium or acquisition premium, if the obligation is a stripped bond or stripped coupon, or if you received Form 1099-OID as a nominee for someone else.

If you did not receive a Form 1099-OID, contact the issuer or check IRS Publication 1212 for OID amounts.

Premium. If you paid more than the face amount for a bond originally issued at a discount, you do not have to report any OID as income. Report the amount shown on Form 1099-OID and then subtract it as discussed in the Filing Pointer at the end of this section.

Acquisition premium. The amount that is shown in Box 1 of Form 1099-OID is not correct if you pay an acquisition premium (more than original issue price *plus* accumulated OID) because such premium reduces the amount of OID you must report as income. *See* IRS Publication 1212 to recompute OID. Report the amount shown on Form 1099-OID and then reduce it, as discussed in the Filing Pointer at the end of this section.

Stripped bonds or coupons. The amount that is shown in Box 1 of Form 1099-OID may not be correct for a stripped bond or coupon; *see* ¶4.22. If it is incorrect, adjust it as discussed in the Filing Pointer at the end of this section.

Nominee. If you receive a Form 1099-OID for an obligation owned by someone else, other than your spouse, you must file another Form 1099-OID for that owner. The OID computation rules shown in IRS Publication 1212 should be used to compute the other owner's share of OID. You file the other owner's Form 1099-OID and a transmittal Form 1096 with the IRS, and give the other owner a copy of the Form 1099-OID. On your own tax return, report the amount shown on the Form 1099-OID you received and then reduce it, as discussed in the Filing Pointer at the end of this section.

Periodic interest reported on Form 1099-OID. If in addition to OID there is regular interest payable on the bond, such interest will be reported in Box 2 of Form 1099-OID. Report the full amount as interest income if you held the bond for the entire year. If you acquired the bond or disposed of it during the year, *see* ¶4.15 for figuring the interest allocable to your ownership period.

REMICS. If you are a regular interest holder in a REMIC (real estate mortgage investment conduit), Box 1 of Form 1099-OID shows the amount of OID you must report on your return and Box 2 includes periodic interest other than OID. If you are a regular interest holder in a single-class REMIC, Box 2 also includes your share of the REMIC's investment expenses. These expenses should be listed in a separate statement and are deductible on Schedule A as a miscellaneous itemized deduction subject to the 2% adjusted gross income floor; *see* ¶19.24.

Reporting OID and Recomputed OID

If you are reporting the full amount of OID from Box 1 of Form 1099-OID, as previously explained, include the amount as interest on your Form 1040, 1040A, or 1040EZ. However, if you are reporting less OID than the amount shown in Box 1 of Form 1099-OID, you must file Form 1040 and fill out Schedule B. Include the full amount shown in Box 1 of Form 1099-OID on Line 1 of Schedule B, along with other interest income. Make a subtotal of the Line 1 amounts and subtract from it the OID you are not required to report. Write "OID Adjustment" on the line where you show the subtraction, or "Nominee distribution," if that is the reason for the reduction. If you are reporting more OID than the amount shown in Box 1 of Form 1099-OID, add the additional amount to the subtotal of the interest on Line 1 of Schedule B, and label it "OID Adjustment."

Your basis for the obligation is increased by the taxable OID for purposes of figuring gain on a sale or redemption; *see* ¶4.23.

¶4.20 Reporting Income on Market Discount Bonds

Market discount arises where the price of a bond declines below its face amount because it carries an interest rate that is below the current rate of interest.

When you realize a profit on a market discount bond, the portion of the profit equal to the accrued discount must be reported as ordinary interest income rather than as capital gain. Alternatively, an election may be made to report the accrued market discount annually instead of in the year of disposition.

These rules apply to taxable as well as tax-exempt bonds *bought after April 30, 1993.* However, there are these exceptions: (1) bonds with a maturity date of up to one year from date of issuance; (2) installment obligations; and (3) U.S. Savings Bonds. Furthermore, you may treat as zero any market discount that is less than one-fourth of one percent (.0025) of the redemption price multiplied by the number of full years after you acquire the bond to maturity. Such minimal discount will not affect capital gain on a sale.

Bonds bought before May 1, 1993. For bonds bought before May 1, 1993, application of the market discount rules depends on whether the bond is taxable or tax exempt, and in the case of taxable bonds, the issue date.

Tax exempt bonds bought before May 1, 1993, are *not* subject to the market discount interest income rule; all the gain at disposition is capital gain.

If you bought a *taxable* bond before May 1, 1993, the market discount interest income rule applies if the bond was issued *after* July 18, 1984. If the bond was issued before July 19, 1984, the market discount interest income rule does *not* apply; however, a portion of the gain on disposition can still be treated as interest income if you borrowed money to purchase or carry a market discount bond acquired after July 18, 1984. As discussed in the next paragraph, interest deductions for such loans are restricted and in the year you sell the bond, gain is treated as interest income to the extent of the deferred interest that is deductible in the year of disposition.

Deferral of interest deduction and ordinary income at disposition if you borrow to buy market discount bonds after July 18, 1984. If you took such a loan, your annual investment interest deductions are generally limited to the excess of the interest expense over the interest income earned on the bond for the year (including OID income, if any) *less* any market discount allocated to the days you held the bond during the year. The limitation on the interest deduction applies to bonds you acquire after July 18, 1984, regardless of the issue date of the bond. The allocation of market discount is based on either the ratable-accrual method or constant-interest method; *see* below.

You can avoid this interest deduction limitation if you elect to report the market discount annually as interest income; *see* below for "How to figure accrued market discount."

In the year you dispose of the bond, you may deduct the interest expenses that were disallowed in prior years because of the above limitations. *Gain* on the disposition is interest income to the extent of the deferred interest you may deduct in the year of disposition; the balance is capital gain.

You may choose to deduct disallowed interest in a year before the year of disposition if you have net interest income from the bond. Net interest income is interest income for the year (including OID) less the interest expense incurred during the year to purchase or carry the bond. This election lets you deduct any disallowed interest expense to the extent it does not exceed the net interest income of that year. The balance of the disallowed interest expense is deductible in the year of disposition.

EXAMPLE

In 1996, you borrowed to buy a market discount bond. During 1996, your interest expense is $1,000. Income from the bond is $900 and ratable market discount allocated to the annual holding period is $75. Thus, only $25 is deductible investment interest ($1,000 – $975), subject to the limitations on investment interest; *see* ¶15.10.

A similar interest deduction limitation will apply every year you hold the bond, assuming you do not elect to report the market discount annually.

In the year you dispose of the bond, interest deferred under the limitation will be deductible, subject to the limits of ¶15.10. Gain on the disposition will be treated as interest income to the extent of this deferred interest deduction.

How to figure accrued market discount. Where the market discount rules apply, gain is taxed as ordinary interest income to the extent of the market discount accrued to the date of sale. There are two methods for figuring the accrued market discount. The basic method, called the *ratable accrual method,* is figured by dividing market discount by the number of days in the period from the date you bought the bond until the date of maturity. This daily amount is

then multiplied by the number of days you held the bond to determine your accrued market discount; *see* Example 1 below.

Instead of using the ratable accrual method to compute accrual of market discount you may elect to figure the accrued discount for any bond under an optional *constant-interest* (economic-accrual) method. If you make the election, you may not change it. The constant-interest method initially provides a smaller accrual of market discount than the ratable method, but it is more complicated to figure.

The complex constant-interest method is generally the same as the constant-yield method used in IRS Publication 1212 to compute taxable OID (¶4.19). For accruing market discount, treat your acquisition date as the original issue date and your basis for the market discount bond (immediately after you acquire it) as the issue price when applying the formula in Publication 1212.

Bonds held to maturity. If you do not report the discount annually and hold a bond until maturity, the discount is reported as interest income in the year of redemption; *see* Example 2 below. You have the option of reporting the market discount annually instead of at sale; *see* below for annual reporting.

Reporting discount annually. Rather than report market discount in the year you sell the bond, you may elect, in the year you acquire the bond, to report market discount currently as interest income. You may use either the ratable accrual method, as in Example 3 below, or the elective constant-interest method discussed earlier. Your election to report annually applies to all market discount bonds subject to the interest income rule that you later acquire. You may not revoke the election without IRS consent. If the election is made, the interest deduction deferral rule discussed earlier does not apply. Furthermore, the election could provide a tax advantage if you sell the bond at a profit and you can benefit from the 28% maximum capital gains rate; *see* ¶5.2.

EXAMPLES

1. You buy a taxable bond issued in 1985 at a market discount of $200. There are 1,000 days between the date of your purchase and the maturity date. The daily accrual rate is 20 cents. You hold the bond for 600 days before selling it for a price exceeding what you paid for the bond. Under the ratable accrual method, up to $120 of your profit is market discount taxable as interest income (600 × 0.20).
2. You paid $9,100 for a $10,000 bond maturing in 1997. If you hold the bond to maturity, you will receive $10,000, giving you a gain of $900 equal to the market discount. The entire $900 market discount will be taxable as interest income in 1997 when the bond is redeemed.
3. In 1996, you buy at a $200 discount a bond that was issued after July 18, 1984. There are 1,000 days between the date of your purchase and the maturity date, so that daily accrual is 20 cents. You elect to report the market discount currently using the ratable accrual method. If you held the bond for 112 days in 1996, on your 1996 return you report $22 as interest income (112 × $0.20).

Partial principal payments on bonds acquired after October 22, 1986. If the issuer of a bond (acquired by you after October 22, 1986) makes a partial payment of the principal (face amount), you must include the payment as ordinary interest income to the extent it does not exceed the accrued market discount on the bond. *See* IRS Publication 550 for options on determining accrued market discount. A taxable partial principal payment reduces the amount of remaining accrued market discount when figuring your tax on a later sale or receipt of another partial principal payment.

Market discount on a bond originally issued at a discount. A bond issued at original issue discount may later be acquired at a market discount because of an increase in interest rates. If you acquire at market discount an OID bond issued after July 18, 1984, the market discount is the excess of: (1) the issue price of the bond *plus* the total original issue discount includible in the gross income of all prior holders of the bond over (2) what you paid for the bond.

Exchanging a market discount bond in corporate mergers or reorganizations. If you hold a market discount bond and exchange it for another bond as part of a merger or other reorganization, the new bond is subject to the market discount rules when you sell it. However, under an exception, market discount rules will not apply to the new bond if the old market discount bond was issued before July 19, 1984, and the terms of interest rates of both bonds are identical.

¶4.21 Discount on Short-Term Obligations

Short-term obligations (maturity of a year or less) may be purchased at a discount from face value. If you are on the cash basis, you report the discount as interest income in the year the obligation is paid. The interest is reported on Form 1099-INT.

EXAMPLE

In May 1995, you paid $920 for a short-term note with a face amount of $1,000. In January 1996, you receive payment of $1,000 on the note. On your 1996 tax return, you report $80 as interest.

Discount must be currently reported by dealers and accrual-basis taxpayers. Discount allocable to the current year must be reported as income by accrual-basis taxpayers, dealers who sell short-term obligations in the course of business, banks, regulated investment companies, common trust funds, certain pass-through entities, and for obligations identified as part of a hedging transaction. Current reporting also applies to persons who separate or strip interest coupons from a bond and then retain the stripped bond or stripped coupon; the accrual rule applies to the retained obligation.

For short-term *governmental* obligations (other than tax-exempts), the acquisition discount is accrued in daily installments under the ratable method, unless an election is made to use the constant-interest method.

For short-term *nongovernmental* obligations, OID is generally taken into account instead of acquisition discount; but an election may be made to report the accrued acquisition discount. *See* IRS Publication 550 for details.

Basis in the obligation is increased by the amount of acquisition discount (or OID for nongovernmental obligations) that is currently reported as income.

Interest deduction limitation for cash-basis investors. A cash basis investor who borrows funds to buy a short-term discount obligation may not fully deduct interest on the loan unless an election is made to report the accrued acquisition discount as income. If the election is not made, a complicated formula limits deductible interest to the excess of the interest expense for the year over the taxable interest from the bond during the year less (1) the portion of the discount allocated to the days you held the bond during the year, and (2) the portion of interest not taxable for the year under your method of accounting. Any interest expense disallowed under this limitation is deductible in the year in which the obligation is disposed.

The interest deduction limitation does *not* apply if you elect to include in income the accruable discount as explained in ¶4.20. The election applies to all short-term obligations acquired during the year and also in all later years.

Gain or loss on disposition of short-term obligations for cash-basis investors. If you have a gain on the sale or exchange of a discounted short-term *governmental* obligation (other than tax-exempt local obligations), the gain is ordinary income to the extent of the ratable share of the acquisition discount received when you bought the obligation. Follow the computation shown in ¶4.27 for Treasury bills to figure this ordinary income portion. Any gain over this ordinary income portion is short-term capital gain; a loss would be a short-term capital loss.

Gain on short-term *nongovernmental* obligations is treated as ordinary income up to the ratable share of OID. The formula for figuring this ordinary income portion is similar to that shown in ¶4.27 for short-term governmental obligations, except that the denominator of the fraction is days from original issue to maturity, rather than days from acquisition. A constant interest method may also be elected to figure the ordinary income portion. Gain above the computed ordinary income amount is short-term capital gain (*see* Chapter 5). For more information, *see* IRS Publication 550.

¶4.22 Stripped Coupon Bonds and Stock

Brokers holding coupon bonds may separate or strip the coupons from the bonds and sell the bonds or coupons to investors. Examples include zero-coupon instruments sold by brokerage houses that are backed by U.S. Treasury bonds (such as CATS and TIGRS).

The U.S. Treasury also offers its version of zero coupon instruments, with the name STRIPS, which are available from brokers and banks.

Brokers holding preferred stock may strip the dividend rights from the stock and sell the stripped stock to investors.

If you buy a stripped bond or coupon, the spread between the cost of the bond or coupon and its higher face amount is treated as original issue discount (OID). This means that you annually report a part of the spread as interest income. For a stripped bond, the amount of the original issue discount is the difference between the stated redemption price of the bond at maturity and the cost of the bond. For a stripped coupon, the amount of the discount is the difference between the amount payable on the due date of the coupon and the cost of the coupon. The rules for figuring the amount of OID to be reported annually are in IRS Publication 1212. *See* ¶4.19 for reporting OID.

If you strip a coupon bond, interest accrual and allocation rules prevent you from creating a tax loss on a sale of the bond or coupons. You are required to report interest accrued up to the date of the sale and also add the amount to the basis of the bond. If you acquired the obligation after October 22, 1986, you must also include in income any market discount that accrued before the date you sold the stripped bond or coupons. The method of accrual depends on the date you bought the obligation; *see* IRS Publication 1212. The accrued market discount is also added to the basis of the bond. You then allocate this basis between the bond and the coupons. The allocation is based on the relative fair market values of the bond and coupons at the date of sale. Gain or loss on the sale is the difference between the sales price of the stripped item (bond or coupons) and its allocated basis. Furthermore, the original issue discount rules apply to the stripped item which you keep (bond or coupon). Original issue discount for this purpose is the difference between the basis allocated to the retained item and the redemption price of the bond (if retained) or the amount payable on the coupons (if retained). You must annually report a ratable portion of the discount.

If you buy stripped preferred stock, or you strip the stock and dispose of the stripped dividend rights, you are treated similarly to purchasers of stripped bonds subject to original issue discount (OID). The difference between the stated redemption price for the preferred stock and the cost of the stock must be reported in annual increments. The "discount" element is reported as ordinary income and not as interest; *see* IRS instructions for reporting details. These rules for stripped preferred stock apply to stripped stock purchased after April 30, 1993.

CAUTION

Recomputing Form 1099-OID Amount

Do not report the amount shown in Box 1 of Form 1099-OID for a stripped bond or coupon or stripped preferred stock as income; that amount must be recomputed under complicated rules described in IRS Publication 1212. *See* ¶4.19 for reporting the recomputed OID on your return.

¶4.23 Sale or Retirement of Bonds and Notes

Gain or loss on the sale, redemption, or retirement of debt obligations issued by a government or corporation is generally capital gain or loss. If the bond was issued before 1955, there is capital gain or loss only if the obligation was issued with interest coupons or in registered form on or before March 1, 1954.

A redemption or retirement of a bond at maturity must be reported as a sale on Schedule D of Form 1040 (¶5.6) although there may be no gain or loss realized.

Corporate bonds with OID issued after 1954 and before May 28, 1969, and government bonds with OID issued before July 2, 1982. If the bonds were originally issued at a discount (OID), you report the OID element as ordinary income when the bonds are sold or redeemed; any gain exceeding OID is reported as capital gain. A loss is a capital loss. IRS Publication 1212 has examples for figuring the amount taxable as ordinary income. The ordinary income amount should be reported as interest income and also added to basis on Schedule D.

Corporate bonds with OID issued after May 27, 1969, and government bonds with OID issued after July 1, 1982. The accrued amount of OID is reported annually as interest income and added to basis; this includes the accrued OID for the year the bond is sold. If the bonds are sold or redeemed before maturity, you realize capital gain for the proceeds over the adjusted basis (as increased by accrued OID) of the bond, provided there was no intention to call the bond before maturity. If there was an intention to call the obligation before maturity, the part of the entire OID that has not yet been included in your income is taxable as ordinary income; the balance is capital gain.

Market discount on bonds is taxable under the rules at ¶4.20.

Tax-exempts. *See* ¶4.26 for discount on tax-exempt bonds.

Obligations issued by individuals. On retirement of an obligation issued by an individual debtor, capital gain treatment does not apply. Capital gain treatment, however, may apply if you sell the obligation to a third party and the obligation is a capital asset; *see* Chapter 5. A note acquired by you in your business for service rendered or for the sale of merchandise is not a capital asset.

EXAMPLE

You bought for $6,000 a second trust note of $10,000 from an individual. You receive payments of principal totaling $4,000. Thus, 60% ($6,000 ÷ $10,000) of the $4,000, or $2,400, is treated as a return on your investment; the $1,600 balance is treated as discount or interest income. You sell the note for $3,800. To determine your profit or loss, you reduce your cost by $2,400 ($4,000 × 60%). Your capital gain is $200:

Selling price of note		$3,800
Less: Cost of note	$6,000	
Return on investment	2,400	
Discount		3,600
Capital gain		$ 200

Tax-Free Interest on State and Local Government Obligations

¶4.24 State and City Interest Generally Tax Exempt

Generally, you pay no tax on interest on bonds or notes of states, cities, counties, the District of Columbia, or a possession of the United States. This includes bonds or notes of port authorities, toll road commissions, utility services activities, community redevelopment agencies, and similar bodies created for public purposes. Bonds issued after June 30, 1983, must be in registered form for the interest to be tax exempt. Interest on federally guaranteed obligations is generally taxable, but *see* exceptions at ¶4.25.

Check with the issuer of the bond to verify the tax-exempt status of the interest.

Private activity bonds. Interest on so-called private activity bonds is generally taxable (*see* ¶4.25), but there are certain exceptions. For example, interest on the following bonds is tax exempt even if the bond may technically be in the category of private activity bonds; qualified student loan bonds; exempt facility bonds; qualified small issue bonds; qualified mortgage bonds and qualified veterans' mortgage bonds; qualified redevelopment bonds; and qualified 501(c)(3) bonds issued by charitable organizations and hospitals.

However, while interest on such bonds is not subject to regular tax, interest that you receive on such bonds issued after August 7, 1986, is considered a tax preference item that may be subject to alternative minimum tax; *see* ¶23.5.

Check with the issuer for the tax status of a private activity bond.

Reporting tax-exempt interest on your return. On your 1996 return, you must list the amount of tax-exempt interest received during the year although it is not taxable. On Form 1040, you list the tax-exempt interest on Line 8b. On Form 1040A, you list the amount on Line 8b. On Form 1040EZ, you write "TEI" and then the amount of tax-exempt interest to the right of the last word on Line 2, but do not include it in the taxable interest shown on Line 2.

Reporting on Schedule B or Schedule 1

If you received a Form 1099-INT showing tax-exempt interest and you are filing Schedule B of Form 1040, you must list the tax-exempt amount along with taxable interest in that schedule. Then, on a separate line above Line 2, make a subtotal of the total interest and from that subtotal subtract the tax-exempt interest; label the subtracted amount as "Tax Exempt Interest." *See* the sample Schedule B at the beginning of this chapter.

If you file Schedule 1 of Form 1040A, use the same method of listing and then subtracting the tax-exempt interest.

¶4.25 Taxable State and City Interest

Interest on certain state and city obligations is taxable. These taxable obligations include federally guaranteed obligations, mortgage subsidy bonds, private activity bonds, and arbitrage bonds.

Federally guaranteed obligations. Interest on state and local obligations issued after April 14, 1983, is generally taxable if the obligation is federally guaranteed, but there are exceptions allowing tax exemptions for obligations guaranteed by the Federal Housing Administration, Department of Veterans Affairs, Bonneville Power Authority, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, Government National Mortgage Corporation, Resolution Funding Corporation, and Student Loan Marketing Association.

Mortgage subsidy bonds. Interest on bonds issued by a state or local government after April 24, 1979, may not be tax exempt if funds raised by the bonds are used for home mortgages. There are exceptions for certain qualified mortgage bonds and veterans' bonds. Check on the tax-exempt status of mortgage bonds with the issuing authority.

Private activity bonds. Generally, a private activity bond is any bond where more than 10% of the issue's proceeds are used by a private business whose property secures the issue, or if at least 5% of the proceeds (or $5 million if less) are used for loans to parties other than governmental units. Interest on such bonds is generally taxable, but there are exceptions as discussed in ¶4.24. Check on the tax status of the bonds with the issuing authority.

Arbitrage bonds. These are state and local bonds issued after October 9, 1969, used to provide funds for reinvestment in higher yielding instruments except where the bond proceeds are part of a required reserve or replacement fund or are being invested temporarily before the purposes of a bond issue can be fulfilled. Interest on arbitrage bonds is taxable.

¶4.26 Tax-Exempt Bonds Bought at a Discount

Original issue discount (OID) on tax-exempt obligations is not taxable, and on a sale or redemption, gain attributed to OID is tax exempt. Gain attributed to market discount is capital gain or ordinary income depending on whether the bond was purchased before May 1, 1993, or on or after that date; *see* ¶4.20.

Original issue discount tax-exempt bond. This arises when a bond is issued for a price less than the face amount of the bond. The discount is considered tax-exempt interest. Thus, if you are the original buyer and hold the bond to maturity, the entire amount of the discount is tax free. If before maturity you sell a bond that was issued before September 4, 1982, and acquired before March 2, 1984, your part of the OID is tax free. On a disposition of a tax-exempt bond issued after September 3, 1982, and acquired after March 1, 1984, you must add to basis accrued OID before determining gain or loss. OID must generally be accrued using a constant-yield method; *see* IRS Publication 1212.

When bonds issued after June 8, 1980, are redeemed before maturity, the portion of the original issue discount earned to the date of redemption is tax-free interest; the balance is capital gain. Bonds issued with an intention to redeem before maturity are not subject to this rule; all interest is tax exempt.

Amortization of premiums is discussed at ¶4.17.

Market discount tax-exempts. A market discount arises when a bond originally issued at not less than par is bought at below par because its market value has declined. If *before* May 1, 1993, you bought at a market discount a tax-exempt bond which you sell for a price exceeding your purchase price, the excess is capital gain. If the bond was held long term, the gain is long term. A redemption of the bond at a price exceeding your purchase price is similarly treated.

However, for market discount tax-exempt bonds purchased *after* April 30, 1993, the ordinary income rules discussed at ¶4.20 apply.

Stripped tax-exempt obligations. OID is not currently taxed on a stripped tax-exempt bond or stripped coupon from the bond if you bought it before June 11, 1987. However, for any stripped bond or coupon you bought or sold after October 22, 1986, OID must be accrued and added to basis for purposes of figuring gain or loss on a disposition. Furthermore, if you bought the stripped bond or coupon after June 10, 1987, part of the OID may be taxable; *see* Publication 1212 for figuring the tax-free portion.

Interest on Treasury Securities and U.S. Savings Bonds

¶4.27 Treasury Bills, Notes, and Bonds

Interest on securities issued by the federal government is fully taxable on your federal return. However, interest on federal obligations is not subject to state or local income taxes. Interest on Treasury bills, notes, and bonds is reported on Form 1099-INT. *See* ¶30.14 and ¶30.18 for investment information on Treasury securities.

Treasury bonds and notes. Treasury notes have maturities of two to 10 years. Treasury bonds have maturities of over 10 years. You report the fixed or coupon interest as interest income in the year the coupon becomes due and payable. Treasury bonds and notes are capital assets; gain or loss on their sale, exchange, or redemption is reported as capital gain or loss on Schedule D; *see* Chapter 5. If you purchased a federal obligation below par (at a discount) after July 1, 1982, *see* ¶4.18 for the rules on reporting original issue discount. If you purchased a Treasury bond or note above par (at a premium), you may elect to amortize the premium; *see* ¶4.17. If you do not elect to amortize and you hold the bond or note to maturity, you have a capital loss.

Treasury bills. These are short-term U.S. obligations issued at a discount with maturities of three, six, or 12 months. On a bill held to maturity, you report as interest the difference between the discounted price and the amount you receive on a redemption of the bills at maturity.

Treasury bills are capital assets and a loss on a disposition before maturity is taxed as a capital loss. If you are a cash-basis taxpayer and have a gain on a sale or exchange, ordinary income is realized up to the amount of the ratable share of the discount received when you bought the obligation. This amount is treated as interest income and is figured as follows:

$$\frac{\text{Days T-bill was held}}{\text{Days from acquisition to maturity}} \times \begin{array}{c}\text{T-bill's value at maturity}\\ \textit{minus}\text{ your cost}\end{array}$$

Any gain over this amount is capital gain; *see* the Example below. Instead of using the above fractional computation for figuring the ordinary income portion of the gain, an election may be made to apply the constant interest method. This method follows the OID computation rules shown in IRS Publication 1212 for obligations issued after 1984, except that the acquisition cost of the Treasury bill would be treated as the issue price in applying the Publication 1212 formula.

Accrual basis taxpayers and dealers who are required to currently report the acquisition discount element of Treasury bills using either the ratable accrual method or the constant yield method (¶4.20) do not apply the above formula on a sale before maturity. In figuring gain or loss, the discount included as income is added to basis.

EXAMPLE

You buy at original issue a six-month $10,000 Treasury bill (180-day maturity) for $9,650 on May 16, 1996. You sell it 90 days later for $9,800. Your entire gain of $150 ($9,800 – $9,650) is taxed as interest income on your 1996 return. Under the ratable daily formula, gain up to $175 would be treated as interest income:

$$\frac{\text{90 days held}}{\text{180 days from acquisition to maturity}} \times \text{\$350 discount} = \text{\$175}$$

Interest deduction limitation. Interest incurred on loans used to buy Treasury bills is deductible by a cash-basis investor only to the extent that interest expenses exceed the following: (1) the portion of the acquisition discount allocated to the days you held the bond during the year; and (2) the portion of interest not taxable for the year under your method of accounting. The deferred interest expense is deductible in the year the bill is disposed of. If an election is made to report the acquisition discount as current income under the rules in ¶4.21 for governmental obligations, the interest expense may also be deducted currently. The election applies to all future acquisitions.

Tax Deferral: T-Bill Maturing Next Year

If you are a cash-basis taxpayer, you may postpone the tax on Treasury bill interest by selecting a Treasury bill maturing next year. Income is not recognized until the date on which the Treasury bill is paid at maturity, unless it has been sold or otherwise disposed of earlier.

¶4.28 Interest on U.S. Savings Bonds

Savings Bond Tables: The Supplement will contain redemption tables showing the 1996 year-end values of Series E and EE U.S. Savings Bonds.

Series E and EE Bonds. Series EE bonds have been available since 1980; before 1980, Series E bonds were issued. Both Series E and Series EE bonds may be cashed for what you paid for them plus an increase in their value over stated periods of time. *See* ¶30.22 for investment information on U.S. Savings Bonds.

The increase in redemption value is taxable as interest, but you do not have to report the increase in value each year on your federal return. You may defer (¶4.29) the interest income until the year in which you cash the bond or the year in which the bond finally matures, whichever is earlier. But if you want, you may report the annual increase by merely including it on your tax return. If you use the accrual method of reporting, you must include the interest each year as it accrues. Savings bond interest is not subject to state or local taxes.

If you initially choose to defer the reporting of interest and later want to switch to annual reporting, you may do so. You may also change from the annual reporting method to the deferral method. *See* ¶4.29 for rules on changing reporting methods.

Education funding. If you buy EE bonds which are used to pay for educational expenses upon redemption, you may be able to exclude the accumulated interest from income. *See* ¶33.3 for the exclusion rules.

Bonds for child. Interest on savings bonds bought in the name of a child will be taxed to the child, even if the parent paid for the bonds and is named as beneficiary. Unless an election is made to report the increases in redemption value annually, the accumulated interest will be taxable to the child in the year he or she redeems the bond, or if earlier, when the bond finally matures. However, if the interest is reported annually by a child under age 14, or the child is under age 14 in the year bonds are redeemed, the interest may be subject to tax at the parent's top rate under the *kiddie tax*; *see* Chapter 24. For example, if a child under age 14 has 1996 investment income over $1,300, the excess is taxed at the parent's top tax rate on the child's 1996 return; *see* ¶24.3. To avoid kiddie tax, savings bond interest may be deferred, as discussed in ¶4.29.

Where the kiddie tax for children under age 14 (¶24.3) does not apply, making the election to report the interest annually may be advisable, such as where the child has little or no other income and the bond interest can be offset by personal deductions. For example, a dependent child is not allowed to claim a personal exemption, but he or she may claim a 1996 standard deduction of at least $650; *see* ¶13.5. If the election to report the savings bond interest currently was made for 1996, up to $650 of the interest would be offset by the standard deduction, assuming the child had no other income.

You may make an election on behalf of your child to report the savings bond interest annually if your child is unable to file his or her own return. To make the election, report the accumulated bond interest and add a statement that the interest will be reported each year. In a later year, the child may change from annual reporting to the deferral method under the rules discussed in ¶4.29.

Bonds must be reissued to make gift. Assume you have bought E or EE bonds and had them registered in joint names of yourself and your daughter. The law of your state provides that jointly owned property may be transferred to a co-owner by delivery or possession. You deliver the bonds to your daughter and tell her they now belong to her alone. According to Treasury regulations, this is not a valid gift of the bonds. The bonds must be surrendered and reissued in your daughter's name.

If you do not have the bonds reissued and you die, the bonds are taxable in your estate. Ownership of the bonds is a matter of contract between the United States and the bond purchaser. The bonds are nontransferable. A valid gift cannot be accomplished by manual delivery to a donee unless the bonds also are surrendered and registered in the donee's name in accordance with Treasury regulations.

Series HH. These bonds are issued only in exchange for E or EE bonds, or for Freedom shares. They are issued at face value and pay semiannual interest that is taxable when received.

To be exchanged for HH bonds, the E or EE bonds must have a redemption value of at least $500. If the total value is not a multiple of $500, you will receive cash for the difference. You report the cash received as interest income to the extent of the unreported interest earned on the EE bonds exchanged.

For example, if you trade EE bonds with a redemption value of $3,723.35 for HH bonds, you get $3,500 in HH bonds and cash of $223.35. Report the cash as interest income to the extent it is unreported interest on the EE bonds exchanged.

Series H. These bonds were available before 1980. They were bought at face value and pay semiannual interest that is taxable when received. If you obtained Series H bonds in an exchange for Series E bonds, and you did not report the E bond interest annually, you do not have to report the interest due on the old E bonds until the H bonds are redeemed or mature, whichever occurs first. H bonds issued after January 1957 cease earning interest when they mature in 30 years. At maturity, or on a disposal before maturity, you must report as interest the accumulated interest from any exchanged E bonds.

Freedom shares. These savings notes were available between 1967 and 1970. They have maturities of 30 years. As with E bonds, owners may defer the reporting of interest until the notes mature.

¶4.29 Deferring U.S. Savings Bond Interest

You do not have to make a special election on your tax return in order to defer the interest on Series E or EE savings bonds. You may simply postpone reporting the interest until the year you redeem the bond or the year in which it reaches final maturity, whichever is earlier. If you choose to defer the interest, you may decide in a later year to begin annual reporting of the increase in value. You may also switch from annual reporting to the deferral method. These options are discussed below.

Changing from deferral to annual reporting. If you have deferred reporting of annual increases in value and want to elect to report annual increases on your 1996 return, make sure you report as 1996 interest income the total of all prior and 1996 increases in value. But next year, report only the increases accruing then, plus increases accruing on bonds newly purchased. Suppose you do not include the annual increase on your 1996 return and later change your mind. If the due date of the return has passed, it is too late to make the election. You may not file an amended return reporting the increase in value for 1996. You have to wait until next year's return to make the election.

Changing from annual reporting to deferral. If you have been reporting annual increases in value, you may change your method and elect to defer interest reporting until the bonds mature or are redeemed. You make the election by filing Form 3115 and attaching it to your federal income tax return for the year of the change. At the top of Form 3115, write "Filed Under Rev. Proc. 89-46." You must identify the bonds for which the election is being made. You may make the election on your 1996 tax return; file the return by the due date plus extensions. You must continue to use the deferred method for at least five years following the year of the change.

Changing to Deferral Method for Children

If your children under age 14 have been reporting the annual increases in value on their savings bonds, and they are subject to the "kiddie" tax (¶24.3), consider making the election on Form 3115 to change to the deferral method. The election would defer tax on the interest that under the kiddie tax is subject to tax at your top marginal tax rate.

Extended maturity periods. E bonds may be held for additional periods of maturity after their initial maturity dates. Bonds held for additional periods increase in value and may be cashed in at any time. If you chose to postpone paying tax on accumulated interest, you may continue to postpone the tax during the extended period. You would then report the entire accumulated interest at the final maturity date or in the year you redeem the bond, whichever occurs earlier; *see* the following Caution.

CAUTION — When Accumulated Interest Becomes Taxable

You may not indefinitely defer the tax on E bond interest. E bonds cease earning interest once the bonds reach their final maturity date. For example, bonds issued during 1956 cease earning interest in 1996, 40 years from the date of issuance. On your 1996 return, you must pay tax on all the accumulated interest on 1956 bonds—unless the bonds are traded for new HH bonds in multiples of $500. E bonds issued in 1966 also reach final maturity in 1996, 30 years from the date of issuance. Exchanging E bonds for HH bonds will continue the tax deferral on E bond interest. *See* ¶30.22 for a listing of final maturity dates.

Changing the form of registration. Changing the form of registration of an E or EE bond may result in tax. Assume you use your own funds to purchase a bond issued in your name, payable on your death to your son. Later, at your request, a new bond is issued in your son's name only. The increased value of the original bond up to the date it was redeemed and reissued in your son's name is taxed to you as interest income.

The Examples below show changes in registration that do not result in an immediate tax.

EXAMPLES

1. Jones buys an E bond and has it registered in his name and in the name of his son as co-owner. Jones has the bonds reissued solely in his own name; he is not required to report the accumulated interest at that time.
2. You and your spouse each contributed an equal amount toward the purchase of a $1,000 E bond, which was issued to you as co-owners. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. Neither of you has to report the interest earned to the date of reissue. But if you bought the $1,000 bond entirely with your own funds, you report half the interest earned to the date of reissue.
3. You add another person's name as co-owner to facilitate a transfer of the bond on death. The change in registration does not result in a tax.

Transfer to a spouse. Interest on U.S. Savings Bonds transferred to a spouse in a divorce or settlement may result in tax to the transferor; *see* ¶6.6.

Transfer to a trust. If you transfer U.S. Savings Bonds to a trust giving up all rights of ownership, you are taxed on the accumulated interest to date of transfer. If, however, you are considered to be the owner of the trust and the interest earned before and after the transfer is taxable to you, you may continue to defer reporting the interest.

Transfer to a charity. Tax on the accumulated E or EE bond interest is not avoided by having the bonds reissued to a philanthropy. Further, tax may not be deferred by first converting E bonds to HH bonds and then reissuing the HH bonds in the philanthropy's name. The IRS held that by having the bonds reissued in the philanthropy's name, the owner realized taxable income on the accumulated bond interest.

Co-Owners of E and EE Bonds Report Interest This Way:

1. You paid for the entire bond: Either you or the co-owner may redeem it. You are taxed on all the interest, even though the co-owner cashes the bond and you receive no proceeds. If the other co-owner does cash in the bond, he or she will receive a Form 1099-INT reporting the accumulated interest. However, since that interest is taxable to you, the co-owner should give you a nominee Form 1099-INT, as explained in the rules for nominee distributions on page 64 in the chart "Who Reports Interest Income."
2. You paid for only part of the bond: Either of you may redeem it. You are taxed on that part of the interest which is in proportion to your share of the purchase price. This is so even though you do not receive the proceeds.
3. You paid for part of the bond, and then had it reissued in another's name. You pay tax only on the interest accrued while you held the bond. The new co-owner picks up his or her share of the interest accruing afterwards.
4. You and another person were named co-owners on a bond bought as a gift by a third party. You are taxed on 50% of the interest income; your co-owner is taxed on the remaining half.

Transfer of an E or EE bond at death. If an owner does not report E or EE bond interest annually and dies before redeeming the bond, the income tax 7477liability on the interest accumulated during the deceased's lifetime becomes the liability of the person who acquires the bond, unless an election is made to report the accrued interest in the decedent's final income tax return; *see* ¶1.12. If the election is not made on the decedent's final return, the new owner may choose to report the accumulated interest annually, or defer reporting it until the bond is redeemed or reaches final maturity, whichever is earlier. If the election is made on the decedent's final return, the new owner is taxable only on interest earned after the date of death.

Estate tax. Where an estate tax has been paid on bond interest accrued during the owner's lifetime, the new bondholder may claim the estate tax as a miscellaneous itemized deduction in the year that he or she pays tax on the accumulated interest. The deduction is *not* subject to the 2% adjusted gross income floor (¶19.1).

Form 1099-INT When Bond Is Cashed

When you cash in an E or EE bond, you receive Form 1099-INT that lists as interest the difference between the amount received and the amount paid for the bond. The form may show more taxable interest than you are required to report because you have regularly reported the interest or a prior owner reported the interest. Report the full amount shown on Form 1099-INT on Schedule B if you file Form 1040, or on Part I of Schedule 1 if you file Form 1040A, along with your other interest income. Enter a subtotal of the total interest and then, on a separate line, reduce the subtotal by the savings bond interest that was previously reported and identify the reduction as "Previously Reported U.S. Savings Bond Interest." The interest is exempt from state and local taxes.

Minimum Interest for Loans and Seller-Financed Debt

¶4.30 Minimum Interest Rules

The law requires a minimum rate of interest to be charged on loan transactions unless a specific exception covers the transaction. Where minimum interest is not charged, the law imputes interest as if the parties agreed to the charge.

The rules are complicated and have been subject to several revisions. There are different minimum interest rates and reporting rules depending on the nature of the transaction. The following discussion provides the important details for understanding the rules. For specific cases and computations, we suggest that you consult IRS regulations for details not covered in this book.

There are two broad classes of transactions:

Loans. These are generally covered by Internal Revenue Code Section 7872. Below-market or low-rate interest loans are discussed at ¶4.31.

Seller-financed sales of property. These are covered by either Internal Revenue Code Section 1274 or Section 483. Seller-financed sales are discussed at ¶4.32. If parties fail to charge the minimum required interest rate, the same minimum rate is imputed by law.

¶4.31 Interest-Free or Below-Market Interest Loans

For many years, the IRS tried to tax interest-free or below-market interest loans. However, court decisions supported taxpayers who argued that such loans did not result in taxable income or gifts. To reverse these decisions, the IRS convinced Congress to pass a law imposing tax on interest-free or low-interest loans made by individuals and businesses. You may not make interest-free or low-interest loans to a relative who uses the loan for personal or investment purposes without adverse income tax consequences, unless the exception discussed in this section for $10,000 or $100,000 loans applies.

Given the complexity of these loan rules, you and your tax advisor should carefully review regulations to the Internal Revenue Code Section 7872 when drafting a loan agreement.

How the imputed interest rules work. If interest at least equal to the applicable federal rate set by the IRS is not charged, the law generally treats a below-market interest loan as two transactions:

1. The law assumes that the lender has transferred to the borrower an amount equal to the "foregone" interest element of the loan. In the case of a loan between individuals, such as a parent and child, the parent is subject to gift tax on this element; in the case of a stockholder borrowing from a company, the element is a taxable dividend; in the case of a loan made to an employee, it is taxable pay.

   Note: For *gift tax* purposes (¶33.1), a term loan is treated as if the lender gave to the borrower the excess of the amount of the loan over the present value of all payments due during the loan term. Demand loans are treated as if the lender gave to the borrower annually the amount of the foregone interest.
2. The law assumes that imputed interest equal to the applicable federal rate is paid by the borrower to the lender. The borrower may claim a deduction for the interest if the funds are used to buy investment property; *see* ¶15.10. An employee treated as having taxable pay from a below-market loan may claim an offsetting job expense deduction, subject to the 2% adjusted gross income floor for miscellaneous itemized deductions; *see* ¶19.1.

A husband and wife are treated as one person for purposes of imputing interest.

No tax withholding is required on interest imputed by the rules of the section.

Charging the applicable federal rate avoids the imputed interest rules. Gift loans qualifying for the $10,000 and $100,000 exceptions are not subject to imputed interest rules. For other loans, the rules imputing income to you as the lender may be avoided by charging interest at least equal to the applicable federal rate. Applicable federal rates are set by the IRS monthly and published in the Internal Revenue Bulletin; you can also get the rates from your local IRS office. For a term loan, the applicable rate is the one in effect as of the day on which the loan is made, computed semiannually. The short-term rate applies to loans of three years or less; the mid-term rate to loans over three and up to nine years; the long-term rate applies to loans over nine years. For a demand loan, the applicable federal rate is the short-term rate in effect at the start of each semiannual period (January and July).

Different computations for different types of loans. There are two general classes of loans:

1. Gift loans, whether term or demand, and nongift demand loans.
2. Nongift term loans.

The distinction is important for figuring and reporting imputed interest. For example, in the case of nongift term loans, the imputed interest element is treated as original issue discount; *see* ¶4.19.

Gift loans and nongift loans payable on demand. As a lender, you are taxable on the "foregone interest," that is, the interest that you would have received had you charged interest at the applicable federal rate over any interest actually charged. The borrower may be able to claim an interest deduction if the funds are used to buy investment property; *see* ¶15.10.

Nongift term loans. A term loan is any loan not payable on demand. As a lender of a nongift term loan, you are taxable on any excess of the loan principal over the present value of all payments due under the loan. The excess is treated as original issue (OID) which you report annually as interest income; *see* ¶4.19.

Gift loans may be exempt from imputed interest rules. In certain cases, gift loans of up to $10,000 may avoid the imputed interest rules. Under another exception, for gift loans of up to $100,000 imputed interest may be completely avoided or limited, depending on the borrower's net investment income.

The $10,000 gift loan exception. In the case of a gift loan to an individual, no interest is imputed to any day on which the aggregate outstanding amount of all loans between the parties is not over $10,000, provided the loan is not attributed to the purchase or carrying of income-producing assets.

LAW ALERT

Gift Loans Up to $100,000

An exception in the law may allow you to give another person an interest-free or low-interest loan of up to $100,000 without having interest income imputed to you. For example, if you give a child or other relative an interest-free loan to buy a home or start a business, the imputed interest rules will not apply provided (1) the total outstanding loan balance owed to you by the borrower at all times during the year does not exceed $100,000, and (2) the borrower's net investment income (¶15.10) is $1,000 or less.

If the borrower's net investment income for the year exceeds $1,000, the imputed interest rules apply, but the imputed interest is limited to his or her net investment income. If on any day during the year the outstanding loan balance owed to you by the borrower exceeds $100,000, interest will be imputed for that day under the regular rules. If a principal purpose of a loan is the avoidance of federal taxes, imputed interest is not limited to the borrower's net investment income.

EXAMPLES

1. At the beginning of 1996, you make a $45,000 interest-free loan to your son, payable on demand, which he uses for a down payment on a home. This is the only outstanding loan between you and your son. In 1996, your son's net investment income is $650. Since the loan does not exceed $100,000, and your son's net investment income does not exceed $1,000, the imputed interest rules do not apply; you do not have to report the "foregone interest" as interest income.

   For gift tax purposes, the foregone interest is a taxable gift. For example, assume that the applicable federal rate for 1996 is 6%. The taxable gift would be the foregone interest of $2,700 ($45,000 × 6%), but *see* ¶33.1 for the annual gift tax exclusion and other gift tax reporting details.

2. Same facts as Example 1 above except that your son's net investment income is $1,500. Since net investment income exceeds $1,000, the imputed interest income rules apply, but the imputed interest is limited to the $1,500 of net investment income. Thus, although the foregone interest using the applicable federal rate is $2,700, you report only $1,500 of imputed interest income.

Exceptions for compensation related loans. A $10,000 exception applies for compensation-related and corporate-shareholder loans, provided the principal purpose of the loan is not tax avoidance. Certain low-interest loans given to employees by their employers to purchase a new residence in connection with a move to a new job location are exempt from the imputed interest requirements.

Loans to continuing care facilities. Senior citizens moving into a community with a continuing care facility are required to pay a fee to the facility. The fee may be treated as a "loan" subject to the imputed interest rules to the extent the fee is refundable and it exceeds specified limits. These rules are discussed in Chapter 34.

Reporting imputed interest. Imputed interest is generally treated as transferred by the lender to the borrower and retransferred by the borrower to the lender on December 31 in the calendar year of imputation and is reported under the regular accounting method of the borrower and lender.

EXAMPLE

On January 1, 1996, Jones Company makes a $200,000 interest-free demand loan to Frank, an employee. The loan remains outstanding for the entire 1996 calendar year. Jones Company has a taxable year ending September 30. Frank is a calendar year taxpayer. For 1996, the imputed compensation payment and the imputed interest payment are treated as made on December 31, 1996.

With gift loans between individuals, interest computed during the borrower's taxable year is treated for both the lender and the borrower as earned on the last day of the borrower's taxable year. Treasury regulations to Section 7872 provide rules for figuring "foregone" interest. Where a demand loan is in effect for the entire calendar year, an "annual blended rate" issued by the IRS to simplify reporting may be used to compute the imputed interest. The blended rate is not available if the loan was not outstanding for the entire year or if the loan balance fluctuated; computations provided by Treasury regulations must be used.

Tax return statement requirements. A lender reporting imputed interest income or a borrower claiming an interest deduction must attach statements to their income tax returns reporting the interest, how it was calculated, and the names of the parties and their tax identification numbers.

¶4.32 Minimum Interest on Seller-Financed Sales

The law requires minimum interest charges for seller-financed sales. If the minimum rate is not charged, the IRS imputes interest at the minimum applicable rate requiring both buyer and seller to treat part of the purchase price as interest even though it is not called interest in the sales contract. Generally, interest at the applicable federal rate (AFR) must be charged; *see* the chart at the end of this section for minimum required rates. For example, investment property is sold on the installment basis for $100,000 and the parties fail to charge adequate interest. Assume the IRS imputes interest of $5,000. For tax purposes, $95,000 is allocated to the sale of the property and the principal amount of the debt; the balance is imputed interest of $5,000, taxable to the seller and deductible by the buyer if allowed under the rules of Chapter 15.

However, when the property is *personal-use* property, such as a residence to be used by the buyer, imputed interest rules do not apply to the buyer. Thus, the buyer may not deduct the imputed interest. His or her deduction is limited to the payment of interest stated in the contract if a deduction is allowed under the home mortgage interest rules in Chapter 15.

Two statute classes. The minimum or imputed interest rules are covered by two Internal Revenue Code statutes: Sections 1274 and 483. Under both, the same minimum interest rates apply but the timing of interest reporting is different, as discussed below.

Section 483 applies to any payment due more than six months after the date of sale under a contract which calls for some or all payments more than one year after the date of sale. If the sales price cannot exceed $3,000, Section 483 does not apply. Transactions within Section 483 are sales or exchanges of: (1) principal residences; (2) any property if total payments, including interest and any other consideration to be received by the seller, cannot exceed $250,000; (3) farms if the total price is $1 million or less; and (4) sales of land between family members to the extent the aggregate sales price of all sales between the same parties in the same year is $500,000 or less.

If the selling price exceeds the respective $250,000, $1 million, or $500,000 amount listed in (2) through (4) above, the sale is subject to Section 1274 reporting rules provided some or all payments

are due more than six months after the date of sale. Section 1274 also applies to all other transactions where neither the debt instrument nor the property being sold is publicly traded as long as some payments are deferred more than six months

Timing of interest reporting. One important practical difference between the two statutes covering minimum interest involves the timing of the reporting and deducting of interest.

Under Section 483, a seller and lender use their regular reporting method for imputed interest. For a cash-basis seller, interest is taxed when received; a cash-basis buyer deducts interest when paid if a deduction is allowable. However, if too much interest is allocated to a payment period, the excess interest is treated as prepaid interest, and the deduction is postponed to the year or years interest is earned. Section 483 also describes imputed interest as unstated interest.

Under Section 1274, the interest element is generally reported by both buyer and seller according to the OID accrual rules, even if they otherwise report on the cash basis. Where the seller financing is below an annual threshold ($2,587,500 for 1996 sales), the parties can elect the cash method to report the interest regardless of the OID and accrual rules if: (1) the seller-lender is on a cash-basis method and is not a dealer of the property sold; and (2) the seller and buyer jointly elect to use the cash method. The cash-basis election binds any cash-basis successor of the buyer or seller. If the lender transfers his interest to an accrual-basis taxpayer, the election no longer applies; interest is thereafter taxed under the accrual-method rules. The OID rules also do not apply to a cash-basis buyer of personal-use property; here, the cash-basis debtor deducts only payments of interest required by the contract, assuming a deduction is allowed under the home mortgage rules of Chapter 15.

Figuring Applicable Federal Rate (AFR). There is no imputed interest if the sales contract provides for interest that is at least equal to the AFR. *See* the chart below for determining the AFR.

Assumptions of loans. The imputed interest rules of Sections 1274 and 483 do not generally apply to debt instruments assumed as part of a sale or exchange, or if the property is taken subject to the debt, provided that neither the terms of the debt instrument nor the nature of the transactions are changed.

Important: *In planning deferred or installment sales, review Treasury regulations to the Internal Revenue Code Sections 483 and 1274 for further examples and details.*

Minimum Interest Rate for Seller Financing

Type—	*Description—*
Applicable federal rates	The IRS determines the AFR rates which are published at the beginning of each month in the Internal Revenue Bulletin. There are three AFR rates depending on the length of the contract: *Short-term AFR*–a term of three years or less. *Mid-term AFR*–a term of over three years but not over nine years. *Long-term AFR*–a term of over nine years. The parties may choose the lowest AFR for the three-month period ending with the month in which a binding written sales contract is entered into. Thus, if the AFR for either of the prior two months is lower than the AFR for the month of contract, the lowest of the three AFRs applies. If insufficient interest is charged, the total unstated interest is allocated to payments under an OID computation.
9% safe harbor rate	If seller financing in 1996 is $3,622,500 or less, the minimum required interest is the lower of 9% compounded semiannually and the applicable federal rate (AFR). The amount of seller financing is the stated principal amount under the contract. If the seller-financed amount exceeds $3,622,500, the minimum interest rate is 100% of the AFR. For sales after 1996, the threshold for the 9% safe harbor will be indexed for inflation. The 9% safe harbor provides a benefit only if it is less than the AFR, but in recent years the AFR has been lower than 9%. Thus, until prevailing interest rates increase, charging interest at the AFR will allow a lower rate than the 9% safe harbor. IRS regulations allow the parties to use an interest rate lower than the AFR if it is shown that the borrower could obtain a loan on an arm's-length basis at lower interest.
Seller-financed sale-leaseback transactions	Interest equal to 110% of AFR must be charged.
Sales of land between family members	To the extent that the sales price does not exceed $500,000 during a calendar year, the minimum interest rate is 6%, compounded semiannually. To prevent multiple sales from being used to avoid the $500,000 limit, the $500,000 ceiling applies to all land sales between family members during the same year. To the extent that the $500,000 sales price limit is exceeded, the general 9% or 100% of AFR rules apply.